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Nos. 1303, 1304 and 1305

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

SINGER SEWING MACHINE COMPANY.

On Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF OF RESPONDENT IN OPPOSITION.

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OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 31a-38a)* is reported in 5 T. C. 851. The *per curiam* opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 40-41), affirming the decision of the Tax Court, is reported in 158 F. 2d 982.

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* The record references are to the Appendix to brief on behalf of the respondent taxpayer, Singer Sewing Machine Company, filed in the Circuit Court of Appeals, and to the appended proceedings in that court.

JURISDICTION.

The judgments of the Circuit Court of Appeals were entered on January 30, 1947. (R. 41-44) The petition for writs of certiorari was filed April 29, 1947. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

The privilege of filing consolidated returns having been withdrawn by statute as to years subsequent to 1933 and consolidated returns having been filed for 1933 and earlier years, what is the "proper value," as prescribed by the revenue laws and the regulations thereunder, of Taxpayer's 1934 opening inventory.

The Taxpayer contends that the "proper value" was	$18,422,333.66
The Tax Court found that the actual closing 1933 inventory was $18,422,333.66, but that its "proper value" after elimination of intercompany profits not subjected to tax was	16,097,317.98
The Commissioner contends that it was	9,990,757.74

Since the value of the inventory affects the amount of profits on subsequent sales, the determination of the above question affects taxable income in 1934 on accrual sales and also in 1934, 1935, 1937 and 1938 on installment sales.

STATEMENT.

The petition for writs of certiorari filed herein does not correctly set out the questions involved in the Tax Court and the Circuit Court of Appeals, nor the effect of the decisions. Throughout the petition there is an implication that Respondent or its affiliated corporations earned income during the period of affiliation which was not subjected to tax by reason of filing consolidated returns. The implication has no support whatever in fact. The effect of the decision rendered by the Tax Court and the judgment entered

thereon was to subject every dollar earned by Respondent and its affiliated corporations to tax liability. The "statement" in the petition omits most of the material facts. It is respectfully suggested that a reading of the findings of fact and the opinion of the Tax Court (R. 32a-38a) will demonstrate the correctness of these assertions.

ARGUMENT.

Section 141(b) of the Revenue Act of 1932 is as follows:

> "(b) Regulations.—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted *in such manner as clearly to reflect the income and to prevent avoidance of tax liability.*" (Italics added)

This section is the same as Section 141(b) of the Revenue Act of 1928 and was referred to in Section 113 of the Revenue Act of 1934 and made applicable to that year.

Pursuant to the authorization contained in the Statute, the Commissioner promulgated regulations. In Article 113(a)(11)-1 of Regulations 86, applicable to 1934, there is the following:

> "The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. This rule is applicable, for instance, to the making of separate returns by the members of an affiliated group of corporations for taxable years beginning after December 31, 1933, due to the withdrawal under the law of the privilege of making consolidated returns. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1933 and is required to make a separate return for the taxable year 1934 and succeeding taxable years, the value of the opening inventory

> to be used in computing such corporation's net income for the taxable year 1934 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year."

It will be observed that the Regulations provide that the opening inventory for 1934 shall be the "proper value" of the closing inventory for 1933. The Tax Court determined that the inventory value in fact used in the consolidated return for 1933 was $18,422,333.66 (R. 33a). It then found as a fact that the proper opening inventory for 1934 was $16,097,317.98. The Court thus reduced the opening inventory in the amount of $2,325,015.68 and thereby added that amount to Respondent's income in 1934 and subsequent years, because that was the amount and the only amount which had not been subjected to tax during the period of consolidated returns. The Statute itself limited the power to make regulations and to make adjustments to the extent necessary to "reflect the income and to prevent avoidance of tax liability." Beyond this, as the Tax Court pointed out, the Commissioner could not go. The Commissioner, in the courts below attempted, and in this petition is attempting, to impose a tax on $6,106,560.24 greater profit than Respondent and its affiliated corporations ever made (R. 35a). The correctness of these statements clearly appears from the findings of fact and the opinion of the Tax Court.

The Tax Court found as a fact:

> "The petitioner, in its accounts and in all returns, used inventories taken upon the basis of cost or market, whichever was lower. * * * " (R. 32a)
>
> "The items in the 1918 opening inventory, which had been bought from Manufacturing, had been sold to the petitioner by Manufacturing prior to 1918 at a profit of $6,106,560.24. A similar intercompany profit in the 1918 closing inventory of the petitioner amounted to $8,245,474.67. The excess of the amount of intercompany profit in the closing inventory over the amount in the opening inventory of the petitioner was

subtracted on the consolidated return for 1918 from the total net income of the affiliated companies in determining consolidated taxable net income for 1918. This same system was used on all of the consolidated returns filed by the group except that the excess was added as consolidated income if the amount of intercompany profit in the opening inventory for a year was larger than the amount in the closing inventory of the petitioner for that year. The total subtractions exceeded the total additions on the consolidated returns for the years 1918 through 1933 by $2,325,015.68.

"The closing inventory of the petitioner used in the consolidated return for 1933 was $18,422,333.66. The intercompany profit represented in that amount was $8,431,575.92. The amount of intercompany profit of Manufacturing in the above closing inventory for 1933, which had escaped taxation under the system used by the petitioner and its affiliates, was $2,325,015.68." (R. 33a)

* * *

"The correct amount of the petitioner's opening inventory for 1934 is $16,097,317.98." (R. 33a)

The Tax Court stated additional pertinent facts in its opinion, including the following:

"The amount which he (the Commissioner) would eliminate from the opening inventory is not the amount of the profit of Manufacturing which has escaped tax under *the method heretofore used by these companies with the approval of the Commissioner. It is $6,106,560.24 greater than the profit which has escaped tax.*" (R. 34a-35a) (Italics added)

* * *

"* * * The adjustments washed out during the consolidated return period, except for the $2,325,015.68 of intercompany profits of Manufacturing which had not yet been reported in 1933 at the end of the consolidated return periods." (R. 35a)

* * *

"* * * The unrecognized gain in this case was $2,325,015.68 and we have adjusted the petitioner's opening inventory accordingly." (R. 37a)

The Tax Court properly applied the controlling statutes and regulations. It found that Taxpayer's closing inventory used in computing consolidated income for 1933 was $18,422,333.66; that intercompany profits in the amount of $2,325,015.68 had escaped tax on consolidated returns; and that the proper adjustment to determine the opening inventory for 1934 was subtraction of the $2,325,015.68 from the $18,422,333.66. It thus determined that the proper value of Taxpayer's opening inventory for 1934 should be $16,097,317.98.

Section 113(a)(11) of the Revenue Act of 1934 provides that, in the case of property acquired by a corporation from an affiliate during a period of affiliation, the basis of the property after affiliation shall be determined in accordance with regulations prescribed by the Commissioner "without regard to intercompany transactions in respect of which gain or loss was not recognized." The section makes applicable to 1934 the provisions of Section 141 of the Revenue Act of 1932, and regulations thereunder.

Section 113(a)(11) of the 1934 Act is the same as Section 113(a)(12) of the Revenue Act of 1928, in which Act the statutory provision originated. In its report on the provision in the 1928 Act, the Ways and Means Committee said:

> "* * * it is necessary to delegate to the Commissioner power to prescribe regulations legislative in character under which the basis will be determined for the computation of gain or loss, and depletion and depreciation, laying down in the section the general standard to guide the Commissioner that intercompany transactions should be disregarded if gain or loss was not recognized."

(House of Representatives Report No. 2, 70th Cong., p. 19-20; 1939-1 Internal Revenue Cumulative Bulletin, Part 2, p. 397. The Senate Finance Committee Report on the provision is to the same effect. Senate Report No. 960, 70th Cong., p. 28; 1939-1 Internal Revenue Cumulative Bulletin, Part 2, p. 428.)

The Tax Court determined that $2,325,015.68 of intercompany profit—and no more—had escaped tax on consolidated returns. It said that on the shift from consolidated returns to separate returns no greater burden should be imposed than necessary to protect the revenue, and determined that taxpayer's inventory of $18,422,333.66 should be reduced by the $2,325,015.68.

The Tax Court said (R. 37a):

> "* * * The implication is clear that no adjustment should be made for intercompany transactions in respect of which gain has been recognized. The unrecognized gain in this case was $2,325,015.68 and we have adjusted the petitioner's opening inventory accordingly. The statute and regulations require that and no more. This is now clearly spelled out in later regulations. See Regulations 104, sec. 23.39(b)(3)."

No Conflict of Decisions is Involved.

We challenge the statement in the petition that there is a conflict between the decisions of the Circuit Court of Appeals for the Third Circuit in these cases and the decision by the Circuit Court of Appeals for the Fifth Circuit in *Magnolia Petroleum Company* v. *Thomas,* 151 F. 2d 1008. The result of the decisions in both cases, as well as in the other cases cited in the petition, was the same. There was added in each case to taxable income for 1934 and subsequent years amounts which had not been subjected to tax during the period of consolidated returns.

The Taxpayer contended in the Tax Court and in the Circuit Court of Appeals that the Commissioner could not increase its taxable income in 1934 and subsequent years in the amount of $2,325,015.68 because it was income of another company and was earned prior to 1929, the effective date of the Revenue Act of 1928. Had the Circuit Court of Appeals sustained this contention there might have been a conflict. In fact, the Tax Court cited the above cases in support of its decision increasing Respondent's taxable income by the amount which was not subjected to tax during the consolidated period.

No Important Question of Federal Law is Involved.

In 1942, the Commissioner amended his regulations regarding consolidated returns. The regulations which have been in effect since that time and which apply to all years beginning after December 31, 1940, have expressly required that the opening inventory of a separate return following a consolidated returns period be adjusted exactly as the Tax Court and the Circuit Court of Appeals adjusted the taxpayer's opening inventory for 1934 in this case. It is submitted that this change in the regulation shows, as nothing else could, that the question involved is not only not an important question of law but is, in truth, only a question of proper accounting practice. Regulations 104, Sec. 23.39 (b)(3).

The Tax Court's Valuation is Final.

The determination of the "proper value" of the Taxpayer's 1934 opening inventory is final and controlling under the principle of *Dobson* v. *Commissioner*, 320 U. S. 489, 64 S. Ct. 239. The situation in the *Dobson* case was very similar in all pertinent particulars to the one in these proceedings. Both cases involve basis and the controlling guide in each case is the term "proper." In the *Dobson* case the Court was dealing with a statutory provision that "proper adjustment shall in all cases be made" for certain items if "properly chargeable to capital account." In these proceedings the statutory provision (Section 141 of the Revenue Acts of 1928, 1932 and 1934) authorized the Commissioner to promulgate regulations to clearly reflect income of the affiliated group and of each corporation in the group to the end that no income would escape taxation during the consolidated return period or on the termination thereof. The regulations provided that the opening inventory for the first year of separate returns should be the "proper value" closing inventory of the consolidated return period.

In the *Dobson* case the Supreme Court said, page 504:

> "What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine."

"Proper value" of inventory involved in these proceedings, which is used to determine a profit or loss on sales of the year, and "proper adjustment" of basis involved in the *Dobson* case to be used in determining gain or loss, it would seem, cannot be distinguished for purposes of the rule of the *Dobson* case. The "proper value" is clearly a valuation and accounting problem, and, likewise, inventory accounting to clearly reflect income is certainly an accounting problem. See also *Kelley Co.* v. *Commissioner* and *Talbot Mills* v. *Commissioner*, 326 U. S. 521.

CONCLUSION.

The result of the decision in the Tax Court, which was affirmed by the Circuit Court of Appeals, was to subject to taxation every dollar of income made by Taxpayer and its affiliated corporations. The Commissioner is attempting to subject to tax over $6,000,000 more than was in fact earned by the group of corporations. On the question of principle, we do not see that the amount involved is relevant. In *Ventura Consolidated Oil Fields* v. *Rogan*, 86 F. 2d 149, 156, the Circuit Court of Appeals for the Ninth Circuit stated:

> "We are unable to discover any difference in the applications of the rules of law or equity in tax cases,

whether the government's claim be for $100 or $10,000,000."

Respectfully submitted,

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